NO. 15040

IN THE

United States Court of Appeals For the Ninth Circuit

D. M. HAGGARD AND NILA HAGGARD, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
HILBERT P. ZARKY,
SHELDON I. FINK,
Attorneys,
Department of Justice,
Washington 25, D. C.

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CITATIONS

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 11-24) are reported at 24 T.C. 1124.

JURISDICTION

This petition for review (R. 26-30) involves income taxes for the calendar year 1949. On July 24, 1953, the Commissioner of Internal Revenue mailed to the

taxpayers a notice of deficiency in the amount of $3,480.96. (R. 7-10.) On September 14, 1953 (R. 3), taxpayers filed a timely petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939 (R. 5-7). The decision of the Tax Court sustaining a deficiency of $3,480.96 was entered on November 9, 1955. (R. 25.) The case is brought to this Court by petition for review filed December 28, 1955. (R. 30.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

The taxpayers, as lessees, simultaneously executed self-styled "Lease" and "Option" agreements under which they "rented" farm property for $10,000 in 1948, and $12,000 in 1949 and had, for $2,000 consideration, an option, which was duly exercised, to purchase the property at the expiration of the lease for an additional $24,000. The property had a fair market value of $48,000.

The question presented is whether the Tax Court was clearly erroneous in its determinations that the taxpayers were not paying rent for the use of the property which would be deductible under the 1939 Code, Section 23 (a)(1)(A), but that the annual "rental" payments were non-deductible since they were intending to and did permit the taxpayers to acquire an equity in the property.

STATUTE INVOLVED

Internal Revenue Code of 1939:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—* * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts, as found by the Tax Court and presented in the record, may be summarized as follows:

D. M. Haggard (hereinafter referred to as taxpayer) and Nila Haggard, husband and wife, operate a ranch in Maricopa County, Laveen, Arizona, comprising, in early 1948, approximately 1,340 acres. On February 9, 1948, taxpayer, as "lessee," simultaneously entered into "Lease" and "Option" agreements with Mr. John Butler, as "lessor," involving 160 acres adjacent to taxpayer's property. It is the effect of these "Lease" and "Option" agreements, and, in particular, the deductibility of the 1949 "rental" payment of $12,000 made thereunder, which is in issue. (R. 12-13.)

The property in question was originally purchased by Mr. Butler in November, 1945, for a price of $40,000 ($10,000 down and the balance in annual installments of $5,000). During 1946, Mr. Butler farmed the entire 160 acres, earning a profit of between $25 to $30 per acre, or $4,000 to $4,800 for the year. In 1947, Mr. Butler leased the 160 acres for one year for $4,000. Mr. Butler testified (R. 85) that he leased this land to a Mr. Strom, who had been a farmer in that area since at least 1934. Since Mr. Butler was required to pay assessments and taxes under this arrangement, in the amount of $156, his net profit for 1947 in respect to the 160 acres was approximately $3,844, which amount was less than the annual payment of $5,000 plus interest which was due on his purchase agreement. Thus, at the end of 1947, Mr. Butler had made a total profit of from $7,844 to $8,644 for the two years he owned the property and had paid the mortgagee $10,000 plus interest for the same period. (R. 15-16.)

In late 1947, or early 1948, Mr. Butler was being pressed by his mortgagee to meet an overdue payment on the purchase price of the property. (R. 16.) He testified that he was also advised by friends (a banker and head of a co-operative) to the effect that "If you owe any money, you better get yourself into shape because this thing is going * * *." (R. 98.) Accordingly, Mr. Butler listed the property for sale with a realtor at $48,000. A number of prospective purchasers responded to this listing, but none made a suitable offer until the first week in February 1948. About February 2, 1948, one week before the lease and option agreements in question were executed, Mr. Butler was

offered $48,000 for the property by the son and son-in-law of one Talby, terms being $8,000 down and the balance in 10 equal installments. (R. 16.)

Before accepting this offer, Mr. Butler, realizing taxpayer owned property on both sides of the acreage involved, decided to offer the land to him. In the event he was not interested, Mr. Butler intended to accept the Talby offer. (R. 16.) The testimony shows that on February 9, 1948, Mr. Butler met with taxpayer and offered to sell the land to him for $48,000. (R. 65, 80, 95.) After some discussion, they went together to the office of taxpayer's attorney. (R. 13.) Mr. Butler testified that he agreed to the suggestion of the attorney (R. 95-96) that the transaction be handled by the execution of a "lease," under which taxpayer would rent the property for the balance of 1948 for $10,000, and $12,000 for 1949, with an "Option," for a separate consideration of $2,000, under which taxpayer would have the right to purchase the 160 acres after January 1, 1950, and before January 10, 1950, for $24,000. (R. 13.) The parties then left the attorney's office, but Mr. Butler, before signing, was concerned about the possible tax consequences of the proposed arrangement and revisited taxpayer's attorney to question this aspect of the transaction. He was assured the entire transaction was properly reportable for tax purposes as a sale. (R. 13.) Later the same day, February 9, 1948, the parties returned to the attorney's office and simultaneously executed the "Lease" and "Option" agreements (R. 13), the pertinent provisions of which are set forth in the Tax Court findings of fact (R. 14-15). At the time the deal was consummated, Mr.

Butler testified that it was his intent to sell the property. (R. 89, 95-96.)

On the same day the agreements were executed, taxpayer paid Mr. Butler the $10,000 "rental" payment for 1948 and the $2,000 consideration for the "Option." (R. 13, 16.) On January 1, 1949, taxpayer paid Mr. Butler the other $12,000 "rental" payment, which amount is in controversy. (R. 16.) The fair or reasonable rental for the property in 1947 would have been $3,000 to $4,000 and in February, 1948, the rental that could reasonably have been expected would have been about $5,000 per year. (R. 17.) Taxpayer testified that during 1949, the year in question, he had only 90 of the 160 acres in crops. (R. 62.)

On April 1, 1949, Mr. Butler borrowed $12,000 from the Valley National Bank of Phoenix and mortgaged the property in question as collateral. On the same day, taxpayer, as optionee, executed a "subordination agreement," subordinating his option to this mortgage. The money received on this mortgage was used by Mr. Butler to pay the original mortgage indebtedness on the property. (R. 17.)

In January, 1950, taxpayer exercised his "Option" by assuming the $12,000 debt of Mr. Butler to the Valley National Bank and paying Mr. Butler the additional $12,000 due on the $24,000 option price. On January 20, 1950, a warranty deed was issued by Butler conveying title to the property to the taxpayer. (R. 17.)

Following the execution of the "Lease" and "Option" agreements, Mr. Butler retained a firm of certified public accountants to prepare his 1948 federal

income tax return and was advised to report the transaction as a sale; Mr. Butler so treated the transaction on his 1948 tax return. Taxpayer treated the $12,000 payment made on January 1, 1949, as rental expense and deducted this amount in computing his 1949 tax. (R. 17-18). The Commissioner of Internal Revenue determined that this payment constituted an installment on the purchase price of the property and was not deductible under Section 23 (a)(1)(A) of the Internal Revenue Code of 1939. (R. 18.)

SUMMARY OF ARGUMENT

Under Section 23 (a)(1)(A) of the Internal Revenue Code of 1939, if taxpayer, by means of payments, is either taking title to, or acquiring an equity in, the property involved, he is not entitled to deduct such payments as rent, regardless of what the parties have called the payments. Whether a taxpayer is paying rent for the mere possession of property or is making an investment in the property is a question of the intention of the parties and is therefore one of fact and should not be disturbed unless clearly erroneous. Furthermore, it is a question which cannot be determined unilaterally and taxpayer has the burden of proving the genuineness of both his and the other party's intent in order to prove that he is not within either of the statutory negatives.

In this case, the Tax Court correctly looked to the evidence as a whole in determining the intention of the parties. There was ample evidence to support the Tax Court's finding that both the parties intended, and taxpayer in fact did, acquire a substantial equity

by means of the "rental" payments. Thus, the Tax Court's finding cannot be said to be clearly erroneous and its decision denying deduction for the payments in question should be affirmed.

ARGUMENT

The Record Supports the Conclusion of the Tax Court That the Payment in Question Is Not Deductible as "Rental" Expense Under Section 23 (a)(1)(A) of the Internal Revenue Code of 1939

The statute in question provides for the deduction from gross income, as a business expense, of rentals required to be paid as a condition to the continued use or possession of property "to which the taxpayer * * * is not taking title or in which he has no equity." These provisions relating to the taking of title or acquiring of an equity are stated in the alternative and the deduction cannot be availed of if the "lessee" has brought himself into either category prohibited by the statute. *Oesterreich* v. *Commissioner,* 226 F. 2d 798 (C.A. 9th). Whether, under a particular instrument or agreement, the taxpayer has brought himself into either category is determined by the intention of the parties to the instrument and the courts will look to this intent to determine whether what is in form a lease is in effect a contract for sale. *Oesterreich* v. *Commissioner, supra; Benton* v. *Commissioner,* 197 F. 2d 745 (C.A. 5th); *Watson* v. *Commissioner,* 62 F. 2d 35 (C.A. 9th); *Jefferson Gas Coal Co.* v. *Commissioner,* 52 F. 2d 120 (C.A. 3d); *Lodbzeiski* v. *Commissioner,* decided October 6, 1944 (1944 P-H T.C. Memorandum Decisions, par. 44,326). In this respect, this Court has

recently stated in *Oesterreich* v. *Commissioner* (pp. 801-802):

> It seems well settled that calling such a transaction a "lease" does not make it such, if in fact it is something else. *Judson Mills,* 1948, 11 T.C. 25; *Robert A. Taft,* 1938, 27 B.T.A. 808. To determine just what it is the courts will look to see what the parties intended it to be. *Benton* v. *Commissioner,* 5 Cir., 1952, 197 F. 2d 745. * * * the test should not be what the parties call the transaction nor even what they may mistakenly believe to be the name of such transaction. What the parties believe the legal effect of such transaction to be should be the criterion. If the parties enter into a transaction which they honestly believe to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it nor how they treat it on their books. We must look, therefore, to the intent of the parties in terms of what they intended to happen.

This question of intent is clearly factual and findings and inferences of fact made by the Tax Court will not be disturbed unless clearly erroneous. *Pacific Homes* v. *United States,* 230 F. 2d 755 (C.A. 9th); *Ward* v. *Commissioner,* 224 F. 2d 547 (C.A. 9th); *Benton* v. *Commissioner, supra,* and cases cited therein. Furthermore, the intention of the parties cannot be determined unilaterally. *Breece Veneer & Panel Co.* v. *Commissioner,* 232 F. 2d 319 (C.A. 7th).

Thus, the burden rested upon the taxpayer to prove that the payments were consideration only for the use of the property, and that he was not taking title

nor was he acquiring an equity by means of his payments under the lease in question. To so prove that he was not within either of these statutory categories, the taxpayer bore the burden of proving that it was both his intent, and the intent of the other party to the transaction, that the legal effect thereof was a lease rather than a contract of sale or other device by which taxpayer was taking title or acquiring an equity. The Tax Court found as a fact that the taxpayer, through the annual rental payments, was acquiring a substantial equity and that it was so intended by the parties. (R. 24.) It is respectfully submitted that the evidence amply supports this conclusion.

The taxpayer, placing conclusive reliance on the technical words of the instruments which the parties used, insists that the parties *intended* a lease of the property for the period of almost two years because they called it a lease and insists that the taxpayer paid nothing but rent in the total amount of $22,000, which he must be allowed to deduct in his tax return, because they called it rent. The taxpayer, of course, must equally insist that the property was purchased by him for $24,000, pursuant to the option (for which he paid $2,000) because the option agreement so states.

This argument, of course, is in flat contradiction to the *Oesterreich* case, *supra*. What the parties call the transactions is unimportant. Even more significant is the teaching of *Oesterreich* that even if the parties (p. 801) "honestly believe" the transactions to be a lease, it will be treated as a contract of sale if "in actuality" it "has all the elements of a contract of sale * * *."

In the present case, it is inconceivable that the taxpayer could have honestly believed that he was renting property having a total value of $48,000 (and which he had an option to purchase for $24,000) by paying a rental of $22,000 for a period of less than two years. (See the taxpayer's answers to the questions propounded by the Tax Court Judge, R. 65-69.) And it is equally inconceivable that the taxpayer could have honestly believed that he was, by paying $2,000 for the option, to become entitled to purchase such property for the small purchase price of $24,000.

However, it is a matter of indifference what the taxpayer did or did not believe. As *Oesterreich* demonstrates, the important consideration is what the parties (p. 802) "intended to happen."

It is obvious that, by the $22,000 payments denominated as rent plus the $2,000 payment for the option, the parties intended that the taxpayer would become entitled to have full ownership of the property by the payment of an additional $24,000 at the end of a period of less than two years. Since the property was worth considerably more, it would be captious to assume that the vendor would have bound himself to sell at such a low price if the $2,000 option had been the only consideration. Quite plainly, it was the so-called rental payments totalling $22,000 plus the $2,000 option payment which formed the consideration enabling the taxpayer to complete the sale for only $24,000. The taxpayer, by means of these payments, acquired a real and substantial equity in the property—an equity which made it imperative that he exercise the option so long as the value of the property did not fall below $24,000.

Code Section 23 (a)(1)(A) *supra,* permits a deduction only for payments made for the use of property; payments made to acquire an interest in property are capital expenditures which are expressly made nondeductible. The payments here were correctly held by the Tax Court to come within the latter category.

A more detailed examination of the record will demonstrate that the Tax Court's decision rests on solid grounds. The intention of the taxpayer and Mr. Butler to effectuate a purchase and sale of the farm property, and for the taxpayer to acquire an equity therein, is established by the facts and circumstances surrounding the execution of the agreements on February 9, 1948, and by the very terms of the agreements. This intent was to be carried out by means of simultaneously executed lease and option agreements, under which taxpayer was to pay $10,000 "rental" in 1948, $12,000 "rental" in 1949, $2,000 consideration for the option on February 9, 1948, and $24,000 under the option in January 1950. (R. 13.) This total of $48,000 was equal to the amount which Mr. Butler sought as a seller of the property (R. 16, 87), had been offered by a prospective purchaser one week prior to these agreements (R. 16, 87-89), and which was found by the Tax Court to approximate the fair value of the land (R. 23). Confronted with such a situation wherein the concept of sale at first glance pervades the entire transaction, there is little doubt that additional inquiry into the substance and legal effect of the agreement, as shown by the intent of the parties, is necessary to determine the deductibility of the rental payment under the statute involved. See *Watson* v. *Commissioner, supra,*

p. 36; see also *Berry* v. *Commissioner,* decided April 3, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,093).

In this respect, the record amply supports an affirmative finding that it was Mr. Butler's belief and intention, on February 9, 1948, that the legal effect of the transaction was a sale. Mr. Butler bought the farm in 1945 for $40,000 and, under the financing arrangements in respect to that purchase, assumed a burden of annual payments of $5,000, plus interest. (R. 15, 97.) His efforts to farm the land in 1946, and his leasing of the property to another farmer in 1947, resulted in a loss in each of those two years. (R. 15, 85.) With this background, coupled with the advice of business friends (R. 98), in late 1947 or early 1948, Mr. Butler desired to sell the property and manifested this intent by listing the property for sale with a real estate agent for $48,000. Several prospects contacted Mr. Butler in respect to the property and on February 2, 1948, he received an offer to purchase the property for $48,000 ($8,000 down and the balance in 10 installments); Mr. Butler intended to accept this offer in the event a better deal could not be made with the taxpayer. (R. 16, 87-89.) Thus, it may be seen that the entire background and course of conduct of Mr. Butler until February 9, 1948 was consistent with a finding that he intended to sell the property involved.

Turning to the date the agreements were executed, it is also clear that this continued to be the intent of Mr. Butler in spite of the form the transaction eventually assumed. Realizing that taxpayer had land

on both sides of the property in question, on February 9th Mr. Butler contacted taxpayer and offered to sell the property to him for $48,000. (R. 65, 80, 95.) At taxpayer's suggestion, they together went to the office of taxpayer's attorney and it was there that the transaction was executed. (R. 13, 42, 76.) At the exact time the deal was consummated, it was the intent of Mr. Butler to sell the property to the taxpayer. Mr. Butler, the taxpayer's own witness, offered the following uncontradicted testimony (R. 89-90):

> Q. (By Mr. Clark): Did you intend to sell this property when you consummated this deal with Mr. Haggard? A. Yes.
>
> * * * *
>
> Q. Can you explain to the Court why it was that these instruments were drawn up the way they were rather than as a straight purchase agreement?
>
> A. Well, sir, I don't know myself, in other words.

Further testimony was as follows (R. 95-96):

> The Court: Mr. Butler, I think you testified that when you got together with Mr. Haggard on the morning when these papers were drawn up, that it was your idea to sell this property for $48,000.
>
> The Witness: Yes.
>
> The Court: Is that what you testified to? Between the time you were in the coffee shop together and the time you got to Mr. Merrill's office, were you and Mr. Haggard continuously together?
>
> The Witness: Until we went up to the office, yes.
>
> The Court: Can you tell me why or wherefore or just what happened, if you know, as to how this got changed over from a $48,000 sale to a lease for

$10,000 for a little less than the entire year '48, $12,000, '49, $2,000 option and $24,000 purchase price? What happened, if you remember, that moved it from one to the other?

The Witness: I discussed it, they discussed it.

The Court: Who discussed it?

The Witness: Mr. Merrill, Mr. Haggard, and myself, and they agreed and I agreed to it at that time that way.

The Court: Well, who suggested it, do you know?

The Witness: I don't remember.

The Court: Did you suggest it?

The Witness: No, sir.

The proposition that Mr. Butler intended the legal effect of this transaction to be a sale is bolstered by his concern and actions in respect to the tax consequences involved. After initially meeting with taxpayer and his attorney, Mr. Butler returned to the attorney's office to question this aspect of the deal. Mr. Butler's testimony is as follows (R. 76):

[Q.] From the time you met Mr. Haggard in the coffee shop of the Hotel Adams until the time the lease, excuse me, the document entitled "lease" and the document entitled "Option" were executed in Mr. Merrill's office, did you consult with any lawyer, tax accountant, or tax attorney?

A. I went back to Mr. Merrill's office during the noon hour and consulted him about it and he tried to explain to me and he called up some tax man, I don't know who he was, I don't remember the name, but he talked to him over the phone and he turned around to me and said I'd just go ahead and report it as a sale, so that's what I did.

Mr. Butler further testified (R. 82):

> Q. And you testified that you left the office and then returned, is that correct?
>
> A. Yes, sir. In other words, it kind of bothered me. I didn't know how it was going to affect my income tax and then I went back up there to get a little information on it and he convinced me, in other words, it was more or less all right, so I went ahead and went on home and got my wife and we come back and signed it, and then next year we reported it as a sale, as a sale in other words.
>
> Q. Did you question the form of the documents?
>
> A. No sir, I didn't because I am not a lawyer and, in other words, I just took the man's word for it.

Furthermore, this intent to sell at this time was corroborated by Mr. Butler's treatment of the transaction as a sale on his 1948 income tax return. (R. 83.) See *Benton* v. *Commissioner, supra,* p. 751; see also *McWaters* v. *Commissioner,* decided June 15, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50,152). Taxpayer clearly did not meet his burden of proving it was Mr. Butler's intent that the legal effect of the transaction was to be a lease. On the contrary, through the testimony of taxpayer's own witness, Mr. Butler, there seems to be ample evidence to support an affirmative inference that Mr. Butler's intent at all times was to effectuate a sale and thereby create an equity in the taxpayer. The background desire and efforts to sell, the events on February 9, 1948 (when Mr. Butler offered to sell to taxpayer and at the suggestion of taxpayer and his attorney the transaction took the form of a lease and option), and Mr. Butler's own

statements of intent in respect to all phases of the transaction prior, during and subsequent to the execution of the documents are all consistent with such a finding. It should be further noted that such a finding may be entirely based on facts other than purely objective economic tests.

Taxpayer presents several facts which are submitted as evidentiary of Mr. Butler's intent to lease the property. (Br. 11-12.) However, the bare fact that he signed a document called a lease is certainly in no way controlling; it is the very problem presented in this type of case to pierce such formal manifestations of intent to reach the substance of the situation. *Oesterreich* v. *Commissioner, supra; Watson* v. *Commissioner, supra.* Mr. Butler's testimony in respect to his visit to a lawyer one week later certainly lends little to detract from a finding that it was his intent to legally effect a sale by the means suggested by taxpayer and his attorney. (R. 76-77.) Likewise, the reference to subsequent dealings with an Internal Revenue agent (Br. 11) seems a strained interpretation of what actually transpired (R. 78-79) and corroborates little except the fact that Mr. Butler was a none too erudite businessman.[1] Furthermore, there is noth-

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[1] Q. Did you ever tell an Internal Revenue agent by the name of Mr. Ritchie that you wanted to pay some $800 or $900 in tax and treat the Haggard payment as rent?

A. We wrangled, I think. It is years ago, last summer, and I think '48, in other words, I don't think I would have had to pay any tax. I didn't pay—I don't think, then, right along there, and I asked my bookkeeper, I says, "How much would it cost me to pay that '49?" See? And he told me about $900, and I told him, "Let's pay it," and I went away and never seen him for a couple of weeks and, finally, maybe quite a little while after, then he

ing inconsistent in the fact that Mr. Butler subsequently mortgaged the property and the fact that it was the intent of the parties that taxpayer was to acquire an equity therein or commence taking title. It is clear that Mr. Butler still held legal title at that time and had a mortgageable equity in the property; it is merely the contention of the Commissioner that taxpayer was then in the process of taking title or acquiring an equity therein (which is sufficient to deny the deduction under the statute) and this certainly left Mr. Butler with some interest of value to a mortgagee, especially since the mortgagee here obtained a subordination agreement from the existing optionee. (R. 17.)

Turning to the intent of the taxpayer, it would seem that he relies principally upon the presentation of the lease itself as evidence thereof. (R. 39.) Contrasted with this are several economic factors which are decidedly relevant and which taxpayer has been unable to explain away. Foremost is the finding of the Tax Court that the fair rental value of the property in 1948 was $3,000 to $4,000, and in 1949 was $5,000 (R. 17), yet taxpayer paid "rentals" of $10,000 and $12,000, respectively, in these two years. The Tax Court, in view of Mr. Butler's earnings from the farm in 1946, rental to an experienced farmer in 1947 for $4,000 (R. 15) and the testimony of taxpayer's own expert appraiser (R. 130-134), had ample support for such a finding. The fact that taxpayer paid rentals

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came out to my place to pick up a couple of watermelon and he says, "We won that case. It is all settled." And that is the way I left it. I told him if that is what it takes, I'll pay it.

Q. In other words, that offer was refused?

A. Well, I don't know whatever happened to it, but, anyway, they told me it was all cleared.

far in excess of the fair market value is of probative value in determining that he intended, and in fact did, acquire an equity in the property by means of these payments. See *Breece Veneer & Panel Co.* v. *Commissioner, supra,* pp. 322, 323; see also *Benton* v. *Commissioner, supra; McWaters* v. *Commissioner, supra.* To counter the inference thus created, taxpayer attempted to show by means of his testimony and exhibit in the form of another lease (R. 46-51) that such rentals were not unusual for him. In view of the remoteness of this other transaction (1955) and the lack of proof of comparability of quality of land, either by taxpayer or his expert, the Tax Court rightfully gave this evidence no weight as to the question of fair rental value, but considered it as to the genuineness of the lease in question. (R. 49.) Taxpayer could also offer only poorly supported reasons why he paid $22,000 to rent the land for two years (plus an option consideration of $2,000) which he, through his expert, himself contended was worth only $21,750 in 1948 and supposedly could be purchased for $24,000. (R. 65-69, 110.) Taxpayer's reasons for only renting, i.e., requiring the land to fulfill a grain contract in 1948 and to allow use of certain other lands in 1949 (R. 44) and his lack of capital and borrowing ability in 1948 (R. 65-69), were far from persuasive. Bare statements and conclusions not supported by sufficiently detailed information are not acceptable. *Birnbaum* v. *Commissioner,* 117 F. 2d 395, 396 (C.A. 7th). The payment of such an excess over the fair and reasonable rental value is even more striking in view of the fact that taxpayer utilized only 90 of the 160 acres for

crops in 1949. (R. 62.) Another significant factor in analyzing the true nature of the rental payments is the Tax Court's finding that the rental payments of $22,000 are about 46 percent of the total considerations of $48,000 passing from taxpayer to Mr. Butler (R. 24), which figure it also found to be the fair value of the land in 1948 (R. 23). *Watson* v. *Commissioner, supra; In re Rainey,* 31 F. 2d 197, 199 (Md.), *Bowen* v. *Commissioner,* 12 T.C. 446. In *Watson* v. *Commissioner,* this Court stated (62 F. 2d, p. 36):

> It is unthinkable that the payment of $47,000, which is about 43 per cent. of the entire consideration, upon property valued at $109,900 is an annual rental, for that is the approximate amount received by the "lessor" during the year 1924.

At this point, it might be commented upon that the Tax Court was certainly not clearly erroneous in its finding that the taxpayer had not met his burden in respect to the value of the property in 1948 and that the value was approximately $48,000. (R. 23.) In view of Mr. Butler's purchase price in 1945 of $40,000 (R. 21, 97), his prior listing at $48,000 (R. 21, 87) and the factor that taxpayer's expert ignored certain valuable water rights in his appraisal (R. 22, 135-137), the Tax Court's finding in this respect seems quite reasonable. The taxpayer's testimony in regards to amounts he paid for other surrounding acreage (R. 52-54) was not supported by any particular proof or expert appraisal and could properly be disregarded. *Birnbaum* v. *Commissioner, supra.* Also, taxpayer at the time he entered into the transaction was fully

aware of the tax consequences of the transaction. (R. 69.) The Commissioner contends that this is of some evidentiary value in showing an intent to utilize the device of a lease and option to effectuate a purchase, and yet gain an immediate tax deduction in respect to property which was otherwise not even depreciable. See *Benton* v. *Commissioner, supra,* p. 753. In view of the foregoing, it is respectfully submitted that taxpayer did not meet his burden of proving that it was not his intent, nor was he not in fact taking title to, or acquiring an equity in, the property by means of rental payments. The taxpayer must prove the statutory negatives. *Oesterreich* v. *Commissioner, supra; Helser Machine & Marine Works, Inc.* v. *Commissioner,* 39 B.T.A. 644.

Taxpayer relies principally on *Breece Veneer & Panel Co.* v. *Commissioner, supra,* and *Benton* v. *Commissioner, supra,* in seeking reversal of the decisions below. (Br. 7-9.)

Taxpayer contends that the Tax Court contravened *Benton* v. *Commissioner, supra,* by basing its conclusion upon objective economic tests and determining the intent of the parties by an application of such tests. (Br. 8-11.) However, the court in the *Benton* case in no way repudiated the use of economic factors in determining the intent of the parties in such a situation. Rather, the court held (p. 752) that the error there was "In undertaking to apply a *purely* objective economic test" (emphasis added) and "The economic relation of the value of the property to the option price was only one factor to be considered in determining intent." In *Breece Veneer & Panel Co.*

v. *Commissioner,* upon which taxpayer relies, the court stated (p. 323) "However, the *Benton* case held that the economic test in itself is only one of the factors to be considered to determine the intention of the parties."[2] Furthermore, it would seem that in particular the comparison of rents paid with the fair rental value of the property, as made by the court below (R. 20, 21), is a relevant test in view of the two decisions relied upon by the taxpayer, wherein the respective courts discuss the relationship of the rents paid and the fair rental value. See *Benton* v. *Commissioner, supra,* p. 753; *Breece Veneer & Panel Co.* v. *Commissioner, supra,* pp. 322, 323. The Tax Court also correctly applied, in terms of relevance, the comparison of the amount of the rental payments to the value of the property (R. 24) to analyze the true nature of the payments. *Watson* v. *Commissioner, supra; Bowen* v. *Commissioner, supra.* There is no doubt that the Tax Court utilized these two sets of economic factors in reaching a conclusion, but that is not to say, as taxpayer contends, that the court regarded the intention of the parties as "merely supplemental to economic 'facts' alone" (Br. 10) or that it solely looked to economic tests in reaching a conclusion, thereby contravening *Benton* v. *Commissioner.* On the contrary, the Tax Court based its conclusion on many factors, as evidenced by its findings (R. 12-18) and conduct of the entire hearing (R. 33-145). The court specifically stated (R. 20):

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[2] See 4 Mertens, Law of Federal Income Taxation, Sec. 25.109; Blumenthal and Harrison, The Tax Treatment of the Lease With an Option to Purchase, 32 Texas L. Rev. 839, 852 (1953-1954); 53 Columbia L. Rev. 277, 279 (1953).

> To properly discern the true character of the payment, therefore, it is necessary to ascertain the intention of the parties as evidenced by the written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed.

The court further stated (R. 24):

> In the light of the foregoing *and upon consideration of the record as a whole,* we are convinced that through the annual rental payments petitioners were in fact acquiring a substantial equity in the property, and that it was so intended by the parties. (Emphasis added.)

In connection with his reliance upon the *Benton* case before this Court and his insistence that the Tax Court erred by applying an objective economic test, it is interesting to note the taxpayer's reversal of position before the Tax Court and on appeal. Before the lower court, taxpayer relied on the Tax Court decision in *Benton* v. *Commissioner,* decided September 20, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50,223), to urge that if the fair market value of the property was not in excess of the option price then taxpayer was not acquiring an equity by means of the rental payments. To support this contention, taxpayer went to great lengths to prove, by means of his own testimony (R. 52-54), and that of an expert appraiser (R. 109-143), that the value of the property was less than the $24,000 option price. Now taxpayer seeks to reverse the decision of the Tax Court on the grounds that objective economic tests were the basis for the

court's conclusion. (Br. 10-11.) The fact of the matter is that the Tax Court did not base its decision upon the test suggested by taxpayer, but instead upon consideration of the record as a whole, including the two economic factors already discussed.[3] The court did not soley rely upon, or over-emphasize, a purely objective economic test and thus did not contravene the rule of *Benton* v. *Commissioner.*

The other case which taxpayer strongly relies upon is *Breece Veneer & Panel Co.* v. *Commissioner, supra.* In respect to this decision, taxpayer appears to argue that, since the Tax Court relied on the rationale there expressed and the decision was reversed on appeal, therefore the Tax Court erred. (Br. 8.) However, the particular rationale cited with approval by the Tax Court was (R. 20):

> The Court held [in *Breece Veneer & Panel Co.*], despite the explicit language of the lease agreement, that since the "rental" payments materially exceeded the current fair rental value of the property, and since the aggregate payments paid prior to the exercise of the option were disproportionate to the relatively small final amount required to acquire title, petitioner was building

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[3] The court did find that the taxpayer did not meet his burden in respect to the fair market value of the land and on February 9, 1948, such value was closer to $48,000 than the $21,750 urged by the taxpayer. It is submitted, the court had ample evidence to support this finding. (R. 22-23.) The court did *not* find, as a corollary to taxpayer's proposition, that since the value of the land is greater than the option price the rental payments are thus establishing an equity. Rather, the finding as to valuation seems to be utilized in corroborating Mr. Butler's intent to sell and to view the transaction as a whole whereby total payments are equivalent to the total value. (R. 21.)

> up a substantial equity interest in the property, as intended by the parties, and that the payments, in reality, were being applied to the agreed purchase price of the property.

The court further stated (R. 20):

> We pointed out in *Bruce* [*sic*] *Veneer and Panel Co., supra,* and *Chicago Stoker Corporation, supra,* that the payments there in question (as in the instant case) may have dual potentialities, that is, they may emerge as partial payments of the agreed purchase price on the one hand or rent for the use of the property on the other. As emphasized in those cases, it is difficult to categorize the payments for income tax purposes. To properly discern the true character of the payment, therefore, it is necessary to ascertain the intention of the parties as evidenced by the written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed.

The Seventh Circuit in no way criticized or overruled the rationale which the Tax Court in the instant case cited as applicable and which is in full harmony with this Court's decision in the *Oesterreich* case *supra.* Rather, the decision in the *Breece* case did no more, in this respect, than hold that the Tax Court erred in its findings and interpretation of facts and did not reverse the court as to its statements that certain economic comparisons are acceptable as evidence of the intention of the parties in such a situation. On the contrary, as already noted, the Seventh Circuit gave implied approval to a comparison of rents actually

paid with fair rental value as being of probative value. See *Breece Veneer & Panel Co.* v. *Commissioner, supra,* pp. 322, 323. The facts in the case at bar are materially different, in respect to the aforementioned comparison of rents, than those upon which the court reversed in the *Breece* case.

Another rule which taxpayer seeks to glean from the *Breece* decision through its citation of *Helvering* v. *San Joaquin Co.,* 297 U.S. 496, is that there can be no equity until the option is exercised. (Br. 8.) If such were the effect of the *Breece* decision, it would, quite plainly, be contrary to this Court's decision in *Oesterreich* and would have to be rejected. However, the Seventh Circuit cited the Supreme Court's decision purely as dictum and an examination of the latter decision shows it to be of extremely doubtful application to a situation such as is here presented.[4] In citing the same decision, the court in *Benton* v. *Commissioner, supra* (p. 752) prefixed its statement as follows:

> *If the parties in good faith actually intended to enter into a lease contract,* then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property. (Emphasis added.)

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[4] The Supreme Court was there dealing with the question of whether real property was "acquired" when a lease with option was made or when the option was exercised for purposes of determining which party held the real interest on March 1, 1913, in computing valuation for capital gains. The decision did not involve the section of the statute in question and the Court's pronouncements in respect to "equitable interests" are certainly not determinative of this issue. See *Helvering* v. *San Joaquin Co., supra,* p. 498.

Taxpayer, quoting (Br. 10) from the *Benton* case, p. 752, also stated that "the parties had full liberty to contract as they pleased" and that they had a right to exercise their own judgment (Br. 13). Aside from the fact that the decisions cited by taxpayer in support of the former contention (Br. 10) were actually cited by the court in support of another proposition,[5] this concept is also prefaced by the court as follows: "*Within the limits of reason,* the parties had a right to exercise their own judgment * * *." (Emphasis added.) *Benton* v. *Commissioner, supra,* p. 752. It is with this limitation in mind that the courts, in such situations, seek to determine the actual substance and nature of the payments termed "rentals."

In summary, the Tax Court correctly pierced the form of this transaction and, by determining the intention of the parties from the record as a whole, ascertained that taxpayer was acquiring a substantial equity in the property by means of his rental payments. It might also be noted that it could equally be held that, under the facts, taxpayer, by such payments, was taking title and it was so intended by the parties. In either instance, deductibility under Section 23(a)(1)(A), *supra,* is precluded.

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[5] To be specific, "Whether what is in form a lease is in effect a conditional sale contract depends on the intention of the parties." *Benton* v. *Commissioner, supra,* p. 752.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
HILBERT P. ZARKY,
SHELDON I. FINK,
Attorneys,
Department of Justice,
Washington 25, D. C.

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